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MEMORANDUM

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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

EA for EGJ

DATE: January 29, 2008

RE: STAFF REPORT FOR ARIZONA PUBLIC SERVICE COMPANY'S
SCHEDULE 3 DOCKET NOS. E-01345A-05-0816, E-01345A-05-0826 AND E-
01345A-05-0827

Attached is the Staff Report on the Appropriate Accounting and Rate Treatment to be
Afforded Incremental Schedule 3 Fees Expected to be Collected as a Result of the Elimination of
Free Footage Allowances in Extending Distribution Lines to Serve New Customers.

EGJ:JD:red

Originator: James Dittmer, Consultant, Utilitech, Inc.

Attachment: Original and thirteen copies

Arizona Corporation Commission
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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**ARIZONA PUBLIC SERVICE COMPANY
DOCKET NOS. E-01345A-05-0816 ET AL**

**REPORT OF THE UTILITIES DIVISION STAFF ON THE
APPROPRIATE ACCOUNTING AND RATE TREATMENT
TO BE AFFORDED INCREMENTAL SCHEDULE 3
FEES EXPECTED TO BE COLLECTED AS A RESULT OF
THE ELIMINATION OF FREE FOOTAGE ALLOWANCES IN
EXTENDING DISTRIBUTION LINES TO SERVE NEW CUSTOMERS**

JANUARY 29, 2008

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I. STAFF CONCLUSIONS AND RECOMMENDATIONS

Staff's significant conclusions, recommendations, and bases for such recommendations regarding the accounting and rate treatment to be afforded incremental receipts expected to be collected by Arizona Public Service Company ("APS" or "Company") as a result of eliminating the free footage allowance for distribution line extensions ordered by Arizona Corporation Commission ("ACC" or "Commission") Decision No. 69663 are summarized as follows:

- All fees received pursuant to elimination of the free footage allowance for distribution line extensions should be considered to be Contributions in Aid of Construction ("CIAC"). Pursuant to the Federal Energy Regulatory Commission's prescribed Uniform System of Accounts *General Plant Instruction*, such contributions should be credited to the plant accounts to which construction costs incurred by APS were charged when extending distribution lines to serve new customers. APS' proposal to record incremental fees expected to be collected pursuant to eliminating the free footage allowance as Miscellaneous Service Revenues should be rejected.
- Commissioner Mayes has raised questions of how the two methodologies being considered for recording Schedule 3 fees will 1) better provide benefits to customers over the short and long run *and*, 2) better mitigate future rate relief. Staff submits that *both* accounting/rate proposals will provide benefits to existing ratepayers over the short and long run and will also mitigate to some extent future rate relief required.

It is reasonable to use a present value analysis both to measure benefits to customers over the long and short run and to evaluate the ability to mitigate future rate relief. As a general proposition, the extent or degree to which one methodology will *appear* to result in more present value savings to customers depends to a significant extent upon the discount rate employed to calculate the revenue requirement stream under the two different approaches.

Discounting the revenue requirement streams under the two methodologies using the Company's before-tax cost of capital (12.07%) yields a slightly lower net present value of revenue requirements under the revenue methodology. Utilizing a lower discount rate, such as APS uses for resource planning purposes (8.0%), indicates that the CIAC methodology results in a lower net present value of revenue requirement streams. Under the CIAC methodology, customers receive *more nominal dollars of revenue requirement savings* from the Schedule 3 fees, though they must wait longer to receive such additional *nominal dollar* savings. That is why under a present value analysis, a *higher* assumed discount rate tends to show that the revenue methodology

is better for ratepayers, while a *lower* assumed discount rate will tend to show that the CIAC methodology is more advantageous for ratepayers.¹

Since a net present value comparison of benefits to ratepayers under the two proposals is inconclusive, Staff relies instead upon other practical and conceptual considerations for its proposal to recommend the CIAC methodology over the revenue methodology for recording incremental Schedule 3 fees.

- If this Commission were to permit APS to record the amounts expected to be collected to cover the cost of line extensions as revenues (over the recommendations of Staff to record such fees as CIAC), the amounts that APS initially collects under Schedule 3 should be deferred until APS files its next rate case, at which time the deferred Schedule 3 revenues should be credited in the development of APS' retail cost of service. APS argues in support of its revenue accounting proposal for the Schedule 3 fees that such methodology is most advantageous to ratepayers. The only way this APS conclusion could reasonably be considered correct is if retail ratepayers are credited for all Schedule 3 revenues received from inception of the Schedule 3 revision.

II. OVERVIEW AND HISTORY OF EVENTS LEADING TO ELIMINATION OF FREE FOOTAGE ALLOWANCE

Prior to the issuance of Decision No. 69663, new customers were provided free footage and/or distribution line extension construction cost allowances. Footage and/or costs in excess of prescribed "free allowance" parameters resulted in new customers paying potentially refundable "advances" and/or agreeing to pay special "facilities charges" calculated pursuant to an APS Economic Feasibility Study. Within Decision No. 69663 issued within Docket No. E-01345A-05-0816 et al, APS was ordered to file "revised line extension tariffs that eliminate any free footage or free allowance and remove any requirement for economic feasibility analysis as otherwise required pursuant to A.A.C. R14-2-207.C.1 and C.2"² The basis for this required tariff change is found at page 97 of Decision No. 69663 that states, in relevant part:

[W]e find that, in view of the unprecedented growth in APS' service territory, granting APS variances to A.A.C. R14-2-207.C.1 and C.2, which require a company to provide a specified footage of distribution line at no charge, is a necessary and appropriate measure to shift the burden of rising distribution infrastructure costs away from the current customer base to growth.

¹ In a present value analysis, the additional nominal dollars of future years savings are *discounted* back to arrive at their value stated in *today's dollars*. The higher the discount rate used to discount future nominal dollars of savings under the CIAC methodology, the lower the present value of such future revenue requirement savings.

² As FURTHER ORDERED found on page 156 of Decision No. 69663.

It is important to note three items surrounding this required tariff change. First, no party had advocated this change in prefiled testimony or exhibits.³ This tariff change is being implemented pursuant to this Commission's own initiative. If any party had made such a proposal to eliminate the free footage allowance *along with a concurrent proposal to treat incremental receipts* from charging the cost of *all* distribution line extensions as *revenues*, that party undoubtedly would have, and most certainly should have, undertaken a calculation and proposed an adjustment to APS' retail cost of service to reflect the impact of such change upon APS' base rate revenue requirements.

Second, the incremental fees to be collected under the revised Schedule 3 are indisputably and unequivocally tied to the distribution plant construction cost required to be incurred to serve new retail customers. Thus, from Staff's perspective, it is intuitive that the *intent* of eliminating the free footage allowance is to defray the significant incremental investment *in distribution plant* that APS is specifically incurring to serve new retail customers.

Third, this tariff change is predicted by APS to significantly increase fees to be collected pursuant to Schedule 3. Specifically, within Exhibit D affixed to Mr. Thomas Mumaw's letter to this Commission dated December 20, 2007 (hereinafter referred to as "APS' December 20th letter"), APS predicts that it will receive incremental Schedule 3 line extension fees as follows:

<u>Year</u>	<u>Amount</u>
2008	\$50 million
2009	117 million
2010	159 – 191 million

These are either *revenues* or *funds to offset current construction costs* – depending upon which accounting/rate treatment this Commission authorizes – that were never considered in any fashion within the development of the retail cost of service underlying the base rates authorized within Decision No. 69663.

III. POSSIBLE ACCOUNTING AND RATE TREATMENTS TO AFFORD SCHEDULE 3 RECEIPTS EXPECTED TO BE COLLECTED TO CONSTRUCT DISTRIBUTION LINE EXTENSIONS TO SERVE NEW CUSTOMERS

Staff has identified three possible accounting and rate treatments that could be afforded the Schedule 3 receipts anticipated to be collected to cover APS' costs to construct distribution line extensions to serve new retail customers – all of which have already been addressed in some fashion in various documents filed in Docket No. E-01345A-05-0816 et al since Decision No. 69633 was issued.

³ APS proposed, and the Utilities Division Staff did not oppose, a construction cost limitation for new line extensions concurrent with the elimination of the free footage allowance. However, no party proposed complete elimination of all line extension cost limitations and free footage allowances that was ultimately ordered by this Commission.

First, as APS proposes, the fees could be recorded as Miscellaneous Service Revenues. Under such accounting/rate treatment, the fees would be considered and recorded as operating revenues available to cover, in part, APS' cost of serving retail customers. As long as there is any retail growth in APS' service territory, it can be expected that *some* amount of Miscellaneous Service Revenues in the form of Schedule 3 receipts would be available to consider within the cost of service employed to develop retail base rates.

Second, as Staff proposes, the fees could be treated as CIAC. Under the CIAC approach, Schedule 3 fees are ultimately recorded as a reduction to plant in service. The reduction in plant in service, in turn, results in a reduction to the retail cost of service in the form of a reduced return requirement, reduced depreciation expense and reduced property tax expense.

Third, the fees could be treated as cost-free capital in the development of the Company's overall weighted cost of capital. This approach is similar, though certainly not identical, to the CIAC approach. Under this approach, a balance sheet account for Cost-Free Contributed Capital would be established. Its balance would be included in the development of the Company's overall cost of capital along with the more traditional long term sources of capital such as common equity, preferred stock and long term debt.

The advantages and disadvantages of the three alternatives for the three different methods of treating the incremental Schedule 3 fees are discussed below.

A. Recording Schedule 3 fees as Miscellaneous Revenues

Advantages of, and arguments for, recording the Schedule 3 fees as Miscellaneous Revenues include:

- *If* base rates recently established pursuant to Decision No. 69663 are not immediately revised downward for the estimated impact of the Schedule 3 change, for some indeterminate period of time, APS will enjoy unanticipated earnings and cash flow. The increased earnings and cash flow will, no doubt, boost the interest coverage ratios and cash flow metrics that credit rating agencies review when analyzing the credit worthiness of APS' and PWCC's debt instruments. Better credit ratings boosted by the unanticipated windfall resulting from the Schedule 3 revenues *could*, in turn, reduce APS'/PWCC's borrowing costs. Further, the increased earnings *could* result in the delay of APS filing another retail rate case, although it is impossible to quantify how much of a delay, if any, would be attributable to allowing APS to retain the unanticipated earnings resulting from the Schedule 3 changes. If rates were not concurrently reduced for anticipated incremental Schedule 3 fees, most of the short term benefits noted herein would enure to the advantage of APS/PWCC shareholders. For reasons discussed below, Staff is recommending that APS *not* be allowed to retain for its shareholders incremental Schedule 3 fees received up until the time of APS' next retail rate case.

- Current or “existing” ratepayers will *initially* receive the largest revenue requirement savings under the revenue proposal, as long as appropriate regulatory treatment is adopted. Staff proposes that, *if* APS’ methodology for recording such fees as revenues were adopted, APS should be ordered to defer such revenues in a regulatory liability account until APS’ next rate case wherein such deferred revenues would be credited to APS’ retail cost of service. If the incremental Schedule 3 fees are deferred for future crediting to APS’ retail cost of service, most of the APS shareholder and credit metrics benefits listed in the first point described above would be eliminated. However, if Schedule 3 fees are initially deferred until APS’ net retail rate case (as Staff recommends *if* the fees are to be recorded as revenues), current or “existing” ratepayers can expect that the otherwise-calculated retail revenue requirement developed in APS’ *next* retail rate case will be fairly significantly reduced. The credit amortization of Schedule 3 revenues deferred would be in addition to, or above and beyond, the revenue requirement savings that would result from considering an ongoing level of Schedule 3 revenues in the cost of service determination. As APS notes, the revenue requirement savings under the revenue methodology is initially quite significant inasmuch the Schedule 3 revenues would result in nearly a dollar-for-dollar reduction in the otherwise-calculated retail revenue requirement.

Disadvantages of recording the Schedule 3 fees as “revenues” include:

- If the ACC were to allow APS to retain the windfall derived from recognizing Schedule 3 fees as revenues without concurrently requiring the incremental receipts to be deferred until APS’ next retail rate case (over the recommendations of Staff), the noted “advantage” of a boost to earnings, cash flow and coverage ratios cited as an “Advantage” above, can be expected to be a short-lived, one-time event. Within APS’ *next* retail rate filing, an “ongoing” level of Schedule 3 “revenues” will be considered and included within retail cost of service revenue requirement development. Once an ongoing level of Schedule 3 revenues are considered within the cost of service development underlying base rates, the one-time boost to earnings predicted for the next two-to-three years will cease to occur.
- The amount of Schedule 3 fees to be collected can be expected to be volatile and difficult to estimate for cost of service development. Indeed, APS has estimated the range to be collected over the next three years to be between \$50 and \$159 million per year. In future rate proceedings, the Commission will have to select the “ongoing” level of Schedule 3 revenues that it chooses to accept as a basis for reducing existing base rates. Inability to accurately predict the amount of Schedule 3 receipts will likely contribute to volatility in APS’ earnings as “actual” revenues received could deviate significantly from rate-case-predicated receipt levels.
- While *initially* reducing rates *faster* and *more significantly* than other alternatives under consideration, eventually a cross-over point will be reached such that

recording the Schedule 3 fees as CIAC – or a reduction to plant in service – results in a lower revenue requirement for retail ratepayers. From that point forward, it is likely that recording the Schedule 3 fees as a reduction to plant (i.e., as CIAC) will result in a lower revenue requirement than recording the fees as revenues.

B. Staff's Proposal of Treating the Incremental Schedule 3 Fees as CIAC

Arguments supporting Staff's proposal for treating the incremental Schedule 3 receipts as CIAC, which ultimately reduce net plant in service, include the following:

- The amount of Schedule 3 "fees" to be collected is tied exactly to expected costs to construct distribution lines to serve new customers. Thus, from a conceptual perspective, it is most appropriate to consider such receipts as *reductions* in plant investment rather than an ongoing stream of revenues available to meet any corporate purpose or reduce overall retail revenue requirements.
- APS should immediately and over the long run experience less earnings attrition than it otherwise would absent the significant Schedule 3 tariff modification. This result should occur because APS' incremental investment needed to serve each new customer will be significantly reduced.
- Retail ratepayers will receive a reduced revenue requirement over the life of the plant that facilitated the collection of the fees. Thus, under the CIAC proposal, there is better matching of costs and benefits than exists with the revenue approach.
- Recording incremental Schedule 3 receipts as CIAC will result in much less rate case controversy and earnings volatility than the proposal to record such receipts as revenues.

Disadvantages of the CIAC approach – which largely mirror the advantages of the revenue approach, include:

- The savings impact to "existing" ratepayers is much slower to be realized than under the revenue approach. While retail ratepayers will begin to realize revenue requirement savings under the CIAC approach in APS' next retail rate case, such savings will initially be much smaller than under the revenue approach.
- The *possible* delay in APS' filing another base rate case is reduced. It is much less likely that APS' *next* rate case will be significantly delayed under the CIAC approach.
- Any short-lived, one-time significant boost to earnings, cash flow and interest coverage ratios that would occur if the Schedule 3 fees were recorded as revenues (that would occur if Schedule 3 fees are *not* deferred as proposed by Staff) would not

materialize under the CIAC approach, or certainly would be de minimus in relationship to APS' revenue approach.

C. Treating Schedule 3 Fees as Cost-Free Capital

Another accounting/rate approach that could be implemented would be to treat all Schedule 3 receipts as a cost-free source of funds in the development of the overall weighted cost of capital. This approach is very similar to the CIAC methodology, but with three distinct disadvantages. First, under the CIAC approach wherein plant is reduced, there would be an attendant savings in the form of reduced depreciation expense that would not materialize under the "cost-free capital" approach. Second, the reduction in recorded plant in service under the CIAC approach would also be expected to result in some amount of reduced property tax expense inasmuch as property taxes are influenced by the recorded book value of plant in service. If the Schedule 3 fees were recorded as cost-free capital rather than a reduction to recorded plant in service, the reduction in expected property tax expense would be forfeited.

Third, if the cost-free funds were considered in the development of the weighted overall cost of capital, revenue requirement savings for retail customers would be diluted. This dilution would occur because the cost-free funds provided exclusively by retail ratepayers would be considered in a total-APS capital structure that would also be supporting non-jurisdictional investments and possibly other investments that would not typically be afforded retail jurisdictional rate base recognition. We have affixed to this Staff Report as Exhibit No. 1 a schedule that demonstrates how treating the Schedule 3 fees as "cost-free capital" rather than CIAC/reduction to plant in service results in a higher revenue requirement – *even before considering and quantifying additional savings in the form of reduced depreciation expense and property tax expense*. Again, the increase in the revenue requirement under the "cost-free capital" approach occurs as a result of the fact that the benefits or savings from the "cost-free" funds being submitted exclusively by retail ratepayers would be indirectly allocated to non-retail-rate base investments (i.e., CWIP, wholesale rate base, non-utility investments, disallowed rate base items, etc.) under the cost-free capital approach.

Staff is also aware of Commissioner Pierce's December 10, 2007-dated letter wherein the Commissioner appears to be questioning whether it might be better for ratepayers if the Schedule 3 funds were considered as "revenues" (as APS has proposed) and again as "cost free" or "low cost" funds in the capital structure. Staff does not believe that it would be equitable to reflect the fees once as "revenues" in cost of service development *and again* as cost-free capital in the capital structure (or CIAC for that matter). If the Schedule 3 fees were to be reflected as revenues within the development of the cost of service they would be considered to be offsetting annual expenses or annual return requirements within a given annual reporting period, or more specifically, within a given test year. In effect, the "value" of one year's worth of Schedule 3 fees would be utilized to offset one year's worth of other operating expenses or one year's worth of return requirements. As the full value of a given year's worth of Schedule 3 fees under the revenue approach would have effectively been "used up," it would be inappropriate to again use these same Schedule 3 fees as cost free/low cost capital or as CIAC/reducing rate base. In

summary, utilizing the Schedule 3 fees in both areas of cost of service development would result in a "double dip" to APS' shareholders, and therefore, Staff cannot endorse such approach.

IV. SHORT- AND LONG-TERM IMPACT TO CUSTOMERS OF EMPLOYING THE CIAC VERSUS REVENUE APPROACH

Clearly, over the short run, treating the Schedule 3 receipts as revenues will result in more significant reductions to retail base rates than the CIAC treatment. As the Company notes, the revenue approach yields a dollar-for-dollar rate impact that results in a faster and initially more significant impact to ratepayers in the early years following implementation of the Schedule 3 change. The CIAC approach *initially* results in a much smaller impact to retail rates. This result occurs because, under the CIAC approach, the Schedule 3 fees would be used to reduce rate base, which reduces the utility's return requirement by only a fraction of what occurs under the revenue approach. Importantly, over the life of the plant that generated the collection of the Schedule 3 fees, the total revenue requirement reduction under the CIAC methodology is greater in *nominal dollars* than under the revenue approach.

However, on a present value basis, whether or not the CIAC or revenue approach is more economic for ratepayers is largely dependent upon the interest rate employed to discount future revenue requirement streams estimated under each approach. Under the CIAC approach, revenue requirement savings for ratepayers resulting from the Schedule 3 receipts are slower to be realized than under the revenue approach. Holding all else constant, if those "future revenue requirement savings" resulting from the CIAC approach are discounted using a high discount rate, the CIAC approach would appear to be less economic to ratepayers on a present value basis. Conversely, if future revenue requirement savings under the CIAC approach are discounted using a relatively low discount rate, the CIAC approach will appear more economic for ratepayers.

Affixed to this Staff Report as Exhibit No. 2 is a printout of an analysis undertaken by APS regarding the net present value of 30 years of revenue requirements to ratepayer for a single vintage of Schedule 3 receipts. The analysis calculates the *nominal* revenue requirement under the CIAC and revenue approaches, and then discounts such revenue requirement streams to arrive at the net present value of revenue requirements under each approach. In the analysis APS assumed that \$1,000 of incremental Schedule 3 receipts were collected to cover the cost of a line extension that has an expected life of 30 years. The key conclusions of the APS analysis are summarized as follows:

- Over the 30-year life of the line extension which facilitated the \$1,000 Schedule 3 receipt, revenue requirements stated in *nominal dollars* is \$1,346 less under the CIAC approach than under the revenue approach.
- When the nominal revenue requirements under the two approaches are discounted utilizing the Company's before-tax cost of capital (i.e., 12.07%), the net present

value of revenue requirements is \$100 *less* employing the revenue approach than occurs employing the CIAC approach.

- When the nominal revenue requirements are discounted utilizing an 8.0% interest rate (a rate that APS purports to frequently use for planning purposes), the net present value of revenue requirements is \$125 *less* employing the CIAC approach than what occurs under the revenue approach.

In support of its revenue approach, APS claims in its December 20th letter to this Commission that:

- There is simply no question that APS' proposed revenue treatment renders benefits to both customers and APS compared to CIAC in both the short term and for many years to come.⁴
- Revenue treatment is advantageous to APS customers during *every* year of a 10-year analysis, producing a present value benefit of some \$380 to \$440 million, depending on the discount rate used and assuming Schedule 3 fees of \$100 million annually.⁵
- Within a 30-year analysis, there is eventually a cross-over point wherein CIAC treatment becomes more advantageous than the revenue approach, but on a net present value basis, the revenue approach yields savings over the CIAC approach of \$250 to \$300 million.⁶

Staff takes exception to the assumptions employed by APS within its various multi-generational analyses, and also to APS' conclusion that there is "simply no question that APS's proposed revenue treatment renders benefits to both customers and APS compared to CIAC in both the short term and for many years to come."

In a nutshell, APS' 10-year and 30-year multi-vintage NPV analyses inappropriately and unfairly calculate revenue requirement savings under the revenue approach over a different period than is calculated under the CIAC approach. As described above, Staff submits that for a *given* vintage of Schedule 3 fees received, the net present value of revenue requirement savings to ratepayers is approximately equal over the life of the plant that generated the fees under both the revenue and CIAC approaches. Ignoring other considerations, with the net present value savings approximately equal under either approach, ratepayers should be indifferent as to which approach is adopted.⁷

⁴ Middle of page 4 of December 20, 2007-dated letter from Thomas Mumaw to the ACC.

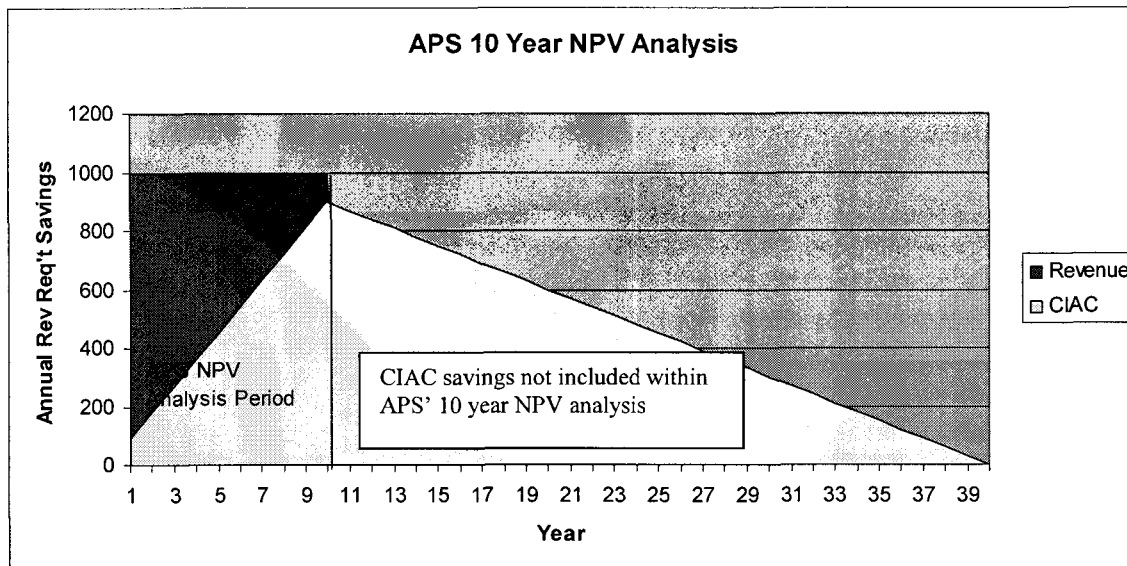
⁵ Last paragraph on page 5 of December 20, 2007-dated letter from Thomas Mumaw to the ACC.

⁶ Last paragraph on page 5 of December 20, 2007-dated letter from Thomas Mumaw to the ACC.

⁷ Staff submits that there are other considerations beyond the NPV analysis that strongly favor treating the Schedule 3 fees as CIAC. But from strictly a NPV analysis, ratepayers should be relatively indifferent as to which approach is adopted.

Within the 10-year analysis underlying APS' claim that ratepayers will realize \$380 – 440 million of net present value revenue requirement savings under the revenue approach, APS has calculated the revenue requirement savings resulting from Schedule 3 fee “revenues” for 10 years. For Schedule 3 fees received in year 10 of the 10-year analysis, the revenue requirement savings under the CIAC approach have only been calculated for one year. As is always the case, savings under the CIAC approach enure to ratepayers over the life of the plant that generated the Schedule 3 fee. Therefore, with a 30-year plant life, as is assumed within APS' modeling exercise, for the tenth year or vintage of Schedule 3 receipts, the revenue requirement savings under the CIAC approach have only been quantified and considered for one of the 30 years in which revenue requirement savings under the CIAC approach are expected.

APS' mismatched analysis is graphically shown on the chart below. Within APS' ten-year NPV analysis the Company discounts the revenue requirement streams under the revenue and CIAC approach for only the first ten years. However, the Schedule 3 receipts received within an initial ten year period will generate CIAC revenue requirement savings for 40 years in total. In short and in sum, APS' 10-year NPV study mixes “apples and oranges” as it fails to consider and calculate savings under the CIAC approach for years 11 through 40 that would occur as a result of Schedule 3 fees received in years one through ten.



Similarly, in its 30-year analysis, APS again inappropriately cuts off its quantification of the net present value of revenue requirement savings under the CIAC approach at the end of 30 years rather than at the end of 60 years as should have appropriately been undertaken. By calculating all the early-years' revenue requirement savings resulting from the revenue approach, but ignoring subsequent years' related revenue requirement savings under the CIAC approach (i.e., beyond 10 and 30 years within APS' 10- and 30-year NPV studies, respectively), APS again creates a significant “mismatch” that results in a bias that erroneously indicates that the revenue approach will *forever* be beneficial to ratepayers.

If APS is permitted to record and retain for its shareholders all of the incremental Schedule 3 fees it begins to collect, it is possible that the timing of APS' next base rate application will be delayed beyond that which would occur under the CIAC approach. It is impossible for Staff to quantify the likelihood or length of any possible delay, but Staff would acknowledge that ratepayers *may* experience a benefit in the form of a delayed base rate increase if the revenue approach is adopted. However, Staff does not envision savings to ratepayers resulting from the possible delay in the timing of APS' next rate filing to approach the savings that ratepayers would realize if the Schedule 3 "revenues" were to be deferred until APS' next rate case – which is Staff's recommendation *if* APS were permitted to consider such Schedule 3 receipts as "revenues."

In short and in summary, Staff continues to maintain that, on a net present value basis, the impact to ratepayers under the revenue or CIAC approach is approximately the same. Accordingly, Staff takes strong exceptions to APS' claimed net present value analyses and ultimately to APS' conclusion that "[t]here is simply no question that APS' proposed revenue treatment renders benefits to both customers and APS compared to CIAC in both the short term and for many years to come."

V. SHORT- AND LONG-TERM IMPACT TO APS OF EMPLOYING THE REVENUE AND CIAC APPROACH

By far, the largest benefit to APS will occur over the next two-to-three years under the revenue approach *if the Company can convince this Commission to not concurrently reduce base rates in this proceeding or defer such receipts for future crediting to ratepayers*. As previously noted, if the Schedule 3 change were implemented without a concurrent order by this Commission to defer such incremental "revenues," APS' shareholders will enjoy an unanticipated and unwarranted increase in pre-tax income of between \$50 and \$159 million per year for years 2008 through 2010. In addition to increasing shareholder earnings above that which would be expected absent the Schedule 3 revision, cash flow indicators and interest coverage ratios will experience a short-lived, one-time improvement above that which would occur absent the Schedule 3 revision.

With the filing of APS' next retail rate application, the benefits of the revenue approach to APS' shareholders and to its other financial metrics will be largely eliminated. This result will occur inasmuch as the "ongoing" level of Schedule 3 revenues will be considered within cost of service development. In other words, the one-time windfall that APS could experience (if the Commission were to accept its proposal to record Schedule 3 fees without a concurrent adjustment to base rates) will have expired, and future earnings and other financial metrics will be similar under the revenue or CIAC approach from that time forward.

In its December 20, 2007-dated letter to this Commission, APS notes that the revenue approach results in an FFO/Debt ratio that is considerably improved relative to the CIAC approach. In particular, APS notes on Exhibit A to its December 20th letter that, under the revenue approach, the FFO/Debt ratio ranges from 19.2% to 20.3% for the years 2008 – 2010,

but falls in the range of 18.1% to 16.2% under the CIAC approach. Staff would note two important items in this regard.

First, as can be observed on Exhibit A, APS assumes that its ACC jurisdictional return on equity will drop to approximately 6.0% over the three-year projection period without filing for additional retail rate relief. If APS filed for retail rate relief and were able to justify a need for relief (in line with its projections of deteriorating returns contained on Exhibit A to APS' December 20th letter), the projected FFO/Debt ratios would not drop to the low levels projected on Exhibit A under the CIAC approach for all years shown.

Second, calculation of FFO entails adding or subtracting, as is applicable, current period net deferred income tax expense to recorded book income. Under the CIAC approach, the *negative* deferred income tax expense that offsets the current income tax impact of CIAC results in a lower amount of calculated FFO. So long as the current formula for calculating FFO remains in effect, there will be a lower FFO amount calculated under the CIAC proposal than under the revenue approach for the foreseeable future. This difference could, at times, push the FFO/Debt ratio to the low end, or below the low end, of the range used by rating agencies as a guideline for an investment grade credit rating.

Staff reminds this Commission that the guidelines used by credit rating agencies are just that – guidelines. Utilities are not automatically or immediately downgraded if they fall below a guideline range for a period of time. Viewed in isolation, rigid adherence to a formula for calculating FFO, in conjunction with rigid adherence to an FFO/Debt guideline range for investment grade ratings, would suggest that the collection of additional CIAC will expose APS to a greater risk of a downgrade than would exist if the Schedule 3 modification had never been authorized. Intuitively, this outcome appears preposterous. It is simply difficult to envision a rating agency, if it truly understood what was being implemented, concluding that a downgrade should occur *as a result of APS effectively reducing its otherwise-calculated capital outlay or need for debt financing*. While Staff would acknowledge that the improvement in the FFO/Debt rating resulting from the recording of Schedule 3 fees as revenues is an argument supportive of the revenue approach, Staff is not convinced that rating agencies will automatically downgrade APS' credit rating when the FFO/Debt falls below the guideline range if the cause of the declining ratio is primarily the impact of negative deferred taxes stemming directly and exclusively from incremental CIAC collections under Schedule 3.

VI. APS' PROPOSAL TO RECORD SCHEDULE 3 FEES AS REVENUES IS EQUIVALENT TO APS' REBUTTAL POSITION TO ADOPT A "REVENUE ENHANCEMENT" PROPOSAL.

During the rate case, APS proposed for the first time in rebuttal testimony a request for authorization for some form of non-traditional "revenue enhancements." Items proposed included: recovery of accelerated depreciation, inclusion of Construction Work in Progress in rate base, as well as an attrition allowance. Staff opposed each of these "revenue enhancement" adjustments proposed by APS, and ultimately this Commission determined that none of the APS-

proposed revenue enhancements should be adopted. It appears to Staff that APS' proposal to record the significant change in Schedule 3 tariff receipts as "Miscellaneous Revenues" could be yet another "revenue enhancement" proposal – not unlike APS' request for an attrition allowance. The negative impact on customers from adopting APS' proposal in this instance would be at least as great as it would have been for the Commission to have adopted the proposed attrition allowance, and certainly greater than would have been the case if the Commission had adopted CWIP in rate base or accelerated depreciation as proposed during the rebuttal phase of the rate case. In addition, APS' proposal regarding Schedule 3 receipts appears to be unprecedented, as opposed to the "revenue enhancement" proposals, each of which had been considered by the Commission in earlier proceedings. Staff fears that the impetus behind APS' efforts to have the Schedule 3 fees recorded as revenues rather than CIAC could be the hope that it can retain for its shareholders somewhere between \$50 and \$159 million per year of before-tax profits up until the time that it files its next retail rate case.

VII. GIVEN THAT FROM A RATE IMPACT PERSPECTIVE RATEPAYERS SHOULD BE INDIFFERENT OVER THE LONG RUN AS TO WHETHER THE CIAC APPROACH OR REVENUE APPROACH IS ADOPTED, STAFF BELIEVES THAT OTHER CONSIDERATIONS INDICATE THE CIAC METHODOLOGY IS THE PREFERRED APPROACH

As noted previously, Staff believes that whether one thinks that ratepayers are better off on a net present value ("NPV") basis under the CIAC or revenue approaches will be largely dependent upon the discount rate assumed. In any event, the NPV difference is not expected to be too significant regardless the approach adopted. Thus, from an NPV of revenue requirements perspective, ratepayers can be expected to be largely indifferent as to whether they achieve faster savings up front (i.e., the revenue approach) or more savings but over a longer period of time (i.e., the CIAC approach). While Staff believes that there is no clear cut preferred approach from an NPV revenue requirement perspective, Staff believes other considerations strongly favor adoption of the CIAC approach.

First, as previously noted, from a conceptual perspective, the purpose of collecting the Schedule 3 fees appears to be to defray the incremental investment cost being incurred to serve new customers. This conclusion is drawn merely by observing that the sole basis for the fees to be collected is the cost of constructing line extensions to serve new customers. Since the basis of collecting such fees is the cost of plant incurred to serve new customers, it logically and consistently follows that the revenue requirement savings resulting from collection of the fees should be spread over the useful life that generated the fees – which is exactly what occurs under the CIAC approach.

Second, also as previously noted, the amount of Schedule 3 fees to be collected can be expected to be quite volatile. One need look no further than APS' estimate of Schedule 3 fees anticipated to be collected for years 2008 – 2010 to observe such volatility. Such volatility in revenues will, in turn, result in volatility of earnings as well as probable controversy in future rate cases when attempting to estimate an "ongoing" or "normalized" level of Schedule 3

revenues to include in cost of service development. Concerns of volatility are eliminated when the CIAC approach is employed. Very simply, Schedule 3 fees will be collected concurrently and in direct proportion with expenditures for distribution line extensions, resulting in lower net investment by APS for new customers being added. The reduction in net plant investment required to serve new customers should, in turn, contribute to less earnings attrition.

In summary, Staff believes that from a conceptual basis (i.e., what are the fees intended to accomplish) and a volatility perspective (i.e., in earnings and rate case issues), the CIAC approach is superior to the revenue approach.

VIII. IF APS' REVENUE APPROACH IS ADOPTED, APS SHOULD BE ORDERED TO EITHER 1) IMMEDIATELY REDUCE BASE RATES BY THE AMOUNT OF SCHEDULE 3 FEES EXPECTED TO BE COLLECTED, OR 2) DEFER FOR FUTURE CREDITING TO RATEPAYERS ANY SCHEDULE 3 FEES COLLECTED UP UNTIL APS' NEXT RETAIL RATE APPLICATION

For the reasons stated, Staff urges this Commission to order APS to record Schedule 3 fees as CIAC. However, should the Commission decide to order APS to record the Schedule 3 fees as revenues, it should concurrently either 1) order APS to defer all receipts for future crediting to retail ratepayers in APS' next retail rate case, or 2) order APS to reduce non-fuel base rates on an equal percentage basis in and among rate classes by the amount of fees expected to be annually collected as a result of the Schedule 3 change.

Turning first to the alternative of reducing rates immediately, Staff believes that reducing non-fuel base rates on an equal percentage basis in and among rate classes would be an expedient and fair way to spread the rate reduction. This methodology has previously been implemented absent a revised detailed class cost of service study. Further, if the Company's financial forecasts are reasonably accurate, the rates stemming from this proceeding will likely be in effect for a relatively short period of time, resulting in no long-term or significant inequitable rate treatment for a given rate class.

The larger problem with implementing an immediate and corollary rate reduction is determining what "ongoing" or "normalized" level of Schedule 3 fees should be assumed to occur. As previously noted, APS predicts a fairly wide range of Schedule 3 fees to be collected over the ensuing three years. Given the lack of historical data, and time and resource restrictions necessary to evaluate this issue, if base rates are to be concurrently reduced for expected Schedule 3 receipts, Staff would propose reducing rates by a simple three-year average of the APS-projected Schedule 3 revenues.

Staff's other alternative to simply have APS defer Schedule 3 revenues received eliminates the concerns of 1) the equitable way to distribute the rate reduction, and 2) immediately determining the appropriate "ongoing" or "normalized" amount of Schedule 3 fees by which base rates should be immediately reduced. Further, while the deferral of Schedule 3 fees will not improve APS' earnings over the short term, it will nonetheless temporarily improve

cash flow to the Company. In light of the noted benefits, Staff recommends deferral of Schedule 3 revenues over the immediate base rate reduction alternative *if this Commission were inclined to accept APS' proposal to record the Schedule 3 fees as "revenues."*

In support of its proposal to have APS defer the Schedule 3 fees for future crediting to ratepayers, Staff notes that such procedure is appropriate for a number of reasons. First, clearly such receipts are a new-found source of significant revenues that were not considered within the development of APS' jurisdictional cost of service. Further, deferring the significant unanticipated Schedule 3 revenues would be symmetrical with the treatment afforded APS regarding significant cost items that the Company was allowed to defer because no estimate for such costs had been included in a prior case jurisdictional cost of service. For instance, in Docket No. E-01345A-03-0437, APS was allowed to defer for future recovery costs that it was expecting to incur for clearing lines related to bark beetle infestation. In fact, the "costs" predicted to be incurred for bark beetle remediation in Docket No. E-01345A-03-0437 were considerably less than the "revenues" that are expected to be received as a result of the Schedule 3 tariff revision. If this Commission is to endorse deferral of significant "costs" not yet considered within base rate cost of service development, then similarly it should authorize deferral of significant new revenue streams that have not yet been considered within retail cost of service development.

Staff also submits that the net present value of revenue requirement streams under the revenue and CIAC approaches will only yield approximately equal results if ratepayers are credited in some fashion for the incremental revenues received in the early years following implementation of the Schedule 3 revision. In other words, the CIAC approach will undoubtedly result in a lower net present value revenue requirement stream if retail ratepayers are permanently barred under the revenue approach from benefiting from the early stream of revenues being collected pursuant to the Schedule 3 revisions.

Finally, APS has argued that the revenue approach is better for customers. As previously noted, Staff believes that APS' penchant to have the Schedule 3 fees immediately recorded as revenues, without a concurrent and offsetting reduction in base rates, may be influenced by its desire to effectively achieve an "attrition allowance" – a proposal which was rejected within Decision No. 69633. Staff submits that if APS were to agree to defer Schedule 3 revenues for the period of time until an "ongoing" level of such revenues can be incorporated within APS' *next* rate filing, that the Staff as well as this Commission could sooner be convinced of APS' conviction that the revenue approach is truly the preferred approach for ratepayers that is not being influenced by a \$50 to \$150 million "carrot" existing in the form of new-found Schedule 3 revenues not yet considered in the ratemaking formula.

Analysis of Revenue Requirement Impact - CIAC versus Cost Free Capital

Balance Sheet Prior to Receipt of Incremental Schedule 3 Fees

	<u>Amount</u>		<u>Amount</u>
Retail Jurisdictional Plant in Service	900	Common Equity	600
FERC Jurisdictional Plant in Service	100	Long Term Debt	600
Construction Work in Progress	100		
Unregulated Investment or Items Not Typically Allowed in Rate Base	<u>100</u>		<u> </u>
Total APS Assets	<u>1,200</u>		<u>1,200</u>

Assume APS' Common Equity and Debt Cost as Follows:

<u>Component</u>	<u>Amount</u>	<u>% of Capital</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>	<u>Revenue Conversion Factor @ 40% FIT/ SIT Tax Rate</u>	<u>Before- Tax COC</u>
Equity	600	50%	10.0%	5.0%	1.667	8.34%
LT Debt	<u>600</u>	<u>50%</u>	<u>7.0%</u>	<u>3.5%</u>		<u>3.5%</u>
Total	1200	100%		<u>8.5%</u>		<u>11.8%</u>

Before Tax Return on Rate Base Requirement - Prior to Receipt of Incremental Schedule 3 Fees:

Retail Jurisdictional Plant in Service	900
Before Tax Weighted Cost of Capital	<u>11.8%</u>
Return Requirement - Prior to Schedule 3	<u>106.56</u>

Analysis of Revenue Requirement Impact - CIAC versus Cost Free Capital

**Balance Sheet After Receipt of Incremental Schedule 3 Fees
Fees Recorded as CIAC/Reduction to Retail Jurisdictional Plant in Service**

	<u>Amount</u>		<u>Amount</u>
Retail Jurisdictional Plant in Service	800	Common Equity	570
FERC Jurisdictional Plant in Service	100	Long Term Debt	570
Construction Work in Progress	100		
CIAC Accum Def Tax = 100% Retail	40		
Unregulated Investment or Items Not Typically Allowed in Rate Base	<u>100</u>		<u> </u>
Total APS Assets	<u>1,140</u>	Total	<u>1,140</u>

**Assume \$100 of Schedule 3 Fees Received in Year One - Recorded as CIAC/Reduction
to Retail Jurisdictional Plant in Service With Partially Off-Setting Negative
Accumulated Deferred Income Tax Balance Which is Reflected as a Rate Base "Add"**

Reduction to Retail Jurisdictional Plant in Service	(100)
Related Negative Accum. Deferred Income Taxes	<u>40</u>
Net Reduction in Retail Jurisdictional Rate Base	(60)
Retail Jurisdictional Rate Base - Schedule 3 Fees Recorded as CIAC/Reduction to Plant in Service	840
Before Tax Cost of Capital (Remains the Same As First Year Under CIAC Approach)	11.8%
Return Requirement When \$100 of Schedule 3 Fees Recorded As CIAC/Reduction to Plant in Service	<u>99.46</u>

**While not quantified herein, there would also be additional revenue requirement savings
in the form of reduced depreciation expense and property tax expense as a result of
plant in service being reduced by \$100 under the CIAC approach.**

Analysis of Revenue Requirement Impact - CIAC versus Cost Free Capital

Balance Sheet After Receipt of Incremental Schedule 3 Fees Fees Recorded as Cost Free Capital

Retail Jurisdictional Plant in Service	900	Common Equity	570
FERC Jurisdictional Plant in Service	100	Long Term Debt	570
Construction Work in Progress	100	Sch. 3 Cost Free Capital Account	100
CIAC Accum Def Tax = 100% Retail	40		
Unregulated Investment or Items Not Typically Allowed in Rate Base	<u>100</u>		
Total APS Assets	<u>1,240</u>		<u>1,240</u>

Assume APS' Common Equity and Debt Cost as Follows:

Component	Amount	% of Capital	Cost Rate	Weighted Cost	Revenue Conversion Factor @ 40% FIT/SIT Tax Rate	Before-Tax COC
Equity	570	45.97%	10.0%	4.6%	1.667	7.66%
LT Debt	570	45.97%	7.0%	3.2%		3.2%
Sch. 3 Cost Free Capital Account	<u>100</u>	<u>8.06%</u>	0.0%	0.0%		0.0%
Total	<u>1,240</u>	100.00%		<u>7.8%</u>		<u>10.9%</u>

Before Tax Return on Rate Base Requirement When Schedule 3 Fees Treated as Cost Free Capital

Retail Jurisdictional Plant in Service	900
CIAC - Accum Def. Income Taxes	40
APS Retail Jurisdictional Rate Base	940
Before Tax Weighted Cost of Capital	<u>10.9%</u>
Return Requirement - Cost Free Capital	<u>102.25</u>

Conclusion: Reflecting the Schedule 3 receipts as "Cost Free Capital" results in a higher revenue requirement than reflecting such receipts as CIAC/reduction to plant in service. The higher retail revenue requirement under the "Cost Free Capital" methodology occurs as a result of the fact that savings in the form of cost free capital are diluted as the "total company" capital structure supports investments other than retail rate base. In effect, the revenue requirement savings resulting from the retail-ratepayer-supplied "Cost Free Capital" are indirectly allocated to supporting the wholesale rate base, CWIP (which typically earns an AFUDC return) and any disallowed retail rate base investment, or unregulated investments on APS' balance sheet. It is noted that the CIAC approach results in savings to retail ratepayers over the "Cost Free Capital" approach even before considering additional savings in the form of reduced depreciation and property tax expense that have not been quantified or reflected with these analyses.

Schedule #3 Fees Treated as CIAC																		
For 1 Vintage Year Over a 30-Year Book Life																		
Line	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Year 16	
1	10,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
2	(1,000)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
3	9,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
4	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	
5	-	(300)	(600)	(900)	(1,200)	(1,500)	(1,800)	(2,100)	(2,400)	(2,700)	(3,000)	(3,300)	(3,600)	(3,900)	(4,200)	(4,500)	(4,800)	
6	9,000	8,700	8,400	8,100	7,800	7,500	7,200	6,900	6,600	6,300	6,000	5,700	5,400	5,100	4,800	4,500	4,200	
7	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	
8	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	
9	3.33%	6.67%	10.00%	13.33%	16.67%	20.00%	23.33%	26.67%	30.00%	33.33%	36.67%	40.00%	43.33%	46.67%	50.00%	53.33%	53.33%	
10	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400	
11	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
12	-	120	240	360	480	600	720	840	960	1,080	1,200	1,320	1,440	1,560	1,680	1,800	1,920	
13	400	520	640	760	880	1,000	1,120	1,240	1,360	1,480	1,600	1,720	1,840	1,960	2,080	2,200	2,320	
14	9,400	9,220	9,040	8,860	8,680	8,500	8,320	8,140	7,960	7,780	7,600	7,420	7,240	7,060	6,880	6,700	6,520	
15	Revenue Requirements on New Rate Base																	
16	-	1,135	1,113	1,091	1,069	1,048	1,026	1,004	982	961	939	917	896	874	852	830	809	
17	-	300	300	300	300	300	300	300	300	300	300	300	300	300	300	300	300	
18	-	131	126	122	117	113	108	104	99	95	90	86	81	77	72	68	63	
19	-	1,566	1,539	1,513	1,486	1,461	1,434	1,408	1,381	1,356	1,329	1,303	1,277	1,251	1,224	1,198	1,172	
20	12.07%																	
21	-	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
22	-	0.89	0.80	0.71	0.63	0.57	0.50	0.45	0.40	0.36	0.32	0.29	0.25	0.23	0.20	0.18	0.16	
23	-	1,397	1,225	1,075	942	826	724	634	555	486	425	372	325	284	248	217	189	
24	11,017																	
25	Schedule #3 Fees Treated as Revenue																	
26	For 1 Vintage Year Over a 30-Year Book Life																	
27	Construction Additions & New Rate Base	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Year 16
28	Plant Additions	10,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
29	No Adjustment for Schedule #3 Fees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
30	Net Plant Additions	10,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31	Cumulative Plant Additions	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
32	Accumulated Book Depreciation	-	(333)	(666)	(999)	(1,332)	(1,665)	(1,998)	(2,331)	(2,664)	(2,997)	(3,330)	(3,663)	(3,996)	(4,329)	(4,662)	(4,995)	(5,328)
33	Original Cost Less Accum. Book Depr.	10,000	9,667	9,334	9,001	8,668	8,335	8,002	7,669	7,336	7,003	6,670	6,337	6,004	5,671	5,338	5,005	4,672
34	20 Year Macrs	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
35	30 Year S/L Book Life	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
36	Cum. Delta	3.33%	6.67%	10.00%	13.33%	16.67%	20.00%	23.33%	26.67%	30.00%	33.33%	36.67%	40.00%	43.33%	46.67%	50.00%	53.33%	53.33%
37	Def. Tax - Taxable Inc. Yr One	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
38	Def. Taxes on Tax Depr Deduction	-	133	267	400	533	667	800	933	1,067	1,200	1,333	1,467	1,600	1,733	1,867	2,000	2,133
39	Accum. Def. Tax on 10,000 Plant Addition	-	133	267	400	533	667	800	933	1,067	1,200	1,333	1,467	1,600	1,733	1,867	2,000	2,133
40	End of Year Rate Base	10,000	9,800	9,601	9,401	9,201	9,002	8,802	8,602	8,403	8,203	8,003	7,804	7,604	7,404	7,205	7,005	6,805
41	Revenue Requirements on New Rate Base																	
42	-	1,207	1,183	1,159	1,135	1,111	1,087	1,062	1,038	1,014	990	966	942	918	894	870	846	822
43	-	333	333	333	333	333	333	333	333	333	333	333	333	333	333	333	333	333
44	-	145	140	135	130	125	120	115	110	105	100	95	90	85	80	75	70	65
45	-	1,665	1,656	1,627	1,598	1,569	1,540	1,510	1,481	1,452	1,423	1,394	1,365	1,336	1,307	1,278	1,249	1,220
46	-	(1,000)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
47	-	685	1,656	1,627	1,598	1,569	1,540	1,510	1,481	1,452	1,423	1,394	1,365	1,336	1,307	1,278	1,249	1,220
48	Discount Rate	12.07%																
49	Years	-	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
50	Discount Factor	1.00	0.89	0.80	0.71	0.63	0.57	0.50	0.45	0.40	0.36	0.32	0.29	0.25	0.23	0.20	0.18	0.16
51	NPV of Yearly Revenue Requirements	-	611	1,319	1,156	1,013	888	777	680	595	521	455	398	348	304	265	231	202
52	NPV of 30 Years of Rev. Req. (12.07% disc't rate)	D																
53	Revenue vs. CIAC Treatment	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Year 16
54	Change in New Rev. Req. Needed	-	(881)	117	114	112	108	106	102	100	96	94	91	88	85	83	80	77
55	Cum. Change in New Rev. Req. Needed	-	(881)	(764)	(650)	(536)	(430)	(324)	(222)	(122)	(26)	68	159	247	332	415	495	572
56	Change in NPV of 30 Years of Rev. Req. (12.07% dr)	-	(100)	56	56	56	56	56	56	56	56	56	56	56	56	56	56	56
57	NPV of same stream discounted at 8%	-	125															

Schedule #3 Fees Treated as CIAC															
For 1 Vintage Year Over a 30-Year Book Life															
Line	Year 17	Year 18	Year 19	Year 20	Year 21	Year 22	Year 23	Year 24	Year 25	Year 26	Year 27	Year 28	Year 29	Year 30	30 Year Totals
Construction Additions & New Rate Base															
1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Plant Additions After CIAC															
4	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000
5	(5,100)	(5,400)	(5,700)	(6,000)	(6,300)	(6,600)	(6,900)	(7,200)	(7,500)	(7,800)	(8,100)	(8,400)	(8,700)	(9,000)	(9,000)
6	3,900	3,600	3,300	3,000	2,700	2,400	2,100	1,800	1,500	1,200	900	600	300	-	-
Original Cost Less Accum. Book Depr.															
7	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0%
8	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	100%
9	56.67%	60.00%	63.33%	66.67%	70.00%	73.33%	76.67%	80.00%	83.33%	86.67%	90.00%	93.33%	96.67%	100.00%	100%
20 Year Macrs Tax Depr. Rate															
10	400	400	400	400	400	400	400	400	400	400	400	400	400	400	400
11	Accum. Def. Tax Reversal on CIAC														
12	2,040	2,160	2,280	2,400	2,520	2,640	2,760	2,880	3,000	3,120	3,240	3,360	3,480	3,600	3,600
13	2,440	2,560	2,680	2,800	2,920	3,040	3,160	3,280	3,400	3,520	3,640	3,760	3,880	4,000	4,000
14	6,340	6,160	5,980	5,800	5,620	5,440	5,260	5,080	4,900	4,720	4,540	4,360	4,180	4,000	207,700
End of Year Rate Base															
Revenue Requirements on New Rate Base															
15	787	765	744	722	700	678	657	635	613	591	570	548	526	505	24,587
16	12.07% Return (incl. Taxes) on Beg. Rate Base														9,000
17	Annual Book Depr. (30 Year Life)	300	300	300	300	300	300	300	300	300	300	300	300	300	300
18	Property Taxes @ 1.5% on OCLD	59	54	50	45	41	36	32	27	23	18	14	9	5	1,965
19	New Rev. Requirements	1,146	1,119	1,094	1,067	1,041	1,014	989	962	936	909	884	857	831	805
Discount Rate															
20	Discount Rate	17	18	19	20	21	22	23	24	25	26	27	28	29	30
21	Years														
22	Discount Factor	0.14	0.13	0.11	0.10	0.09	0.08	0.07	0.06	0.06	0.05	0.04	0.04	0.04	0.03
23	NPV of Yearly Revenue Requirements	165	144	126	109	95	83	72	62	54	47	41	35	31	26
24	NPV of 30 Years of Rev. Req. (12.07% disc't rate)														11,017
Schedule #3 Fees Treated as Revenue															
For 1 Vintage Year Over a 30-Year Book Life															
25	Construction Additions & New Rate Base														
26	Plant Additions	-	-	-	-	-	-	-	-	-	-	-	-	-	-
27	No Adjustment for Schedule #3 Fees	-	-	-	-	-	-	-	-	-	-	-	-	-	-
28	Net Plant Additions	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Cumulative Plant Additions															
31	Cumulative Plant Additions	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
32	Accumulated Book Depreciation	(5,861)	(5,994)	(6,327)	(6,660)	(6,994)	(7,328)	(7,662)	(7,996)	(8,330)	(8,664)	(8,998)	(9,332)	(9,666)	(10,000)
33	Original Cost Less Accum. Book Depr.	4,339	4,006	3,673	3,340	3,006	2,672	2,338	2,004	1,670	1,336	1,002	668	334	-
20 Year Macrs															
34	20 Year Macrs	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0%
35	30 Year S/L Book Life	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	100%
36	Cum. Delta	56.67%	60.00%	63.33%	66.67%	70.00%	73.33%	76.67%	80.00%	83.33%	86.67%	90.00%	93.33%	96.67%	100.00%
Def. Tax - Taxable Inc. Yr One															
37	Def. Tax - Taxable Inc. Yr One	-	-	-	-	-	-	-	-	-	-	-	-	-	-
38	Def. Taxes on Tax Depr Deduction	2,267	2,400	2,533	2,667	2,800	2,933	3,067	3,200	3,333	3,467	3,600	3,733	3,867	4,000
39	Accum. Def. Tax on 10,000 Plant Addition	2,267	2,400	2,533	2,667	2,800	2,933	3,067	3,200	3,333	3,467	3,600	3,733	3,867	4,000
End of Year Rate Base															
40	End of Year Rate Base	6,606	6,406	6,206	6,007	5,806	5,605	5,405	5,204	5,003	4,803	4,602	4,401	4,201	4,000
Revenue Requirements on New Rate Base															
41	Revenue Requirements on New Rate Base														
42	12.07% Return (incl. Taxes) on Beg. Rate Base	821	797	773	749	725	701	677	652	628	604	580	555	531	507
43	Annual Book Depr. (30 Year Life)	333	333	333	333	334	334	334	334	334	334	334	334	334	334
44	Property Taxes @ 1.5% on OCLD	65	60	55	50	45	40	35	30	25	20	15	10	5	-
45	New Rev. Requirements Before Sch. #3	1,219	1,190	1,161	1,132	1,104	1,075	1,046	1,016	987	958	929	899	870	841
46	Schedule 3 Fee Revenue	-	-	-	-	-	-	-	-	-	-	-	-	-	-
47	New Rev. Requirements	1,219	1,190	1,161	1,132	1,104	1,075	1,046	1,016	987	958	929	899	870	841
Discount Rate															
48	Discount Rate	17	18	19	20	21	22	23	24	25	26	27	28	29	30
49	Years														
50	Discount Factor	0.14	0.13	0.11	0.10	0.09	0.08	0.07	0.06	0.06	0.05	0.04	0.04	0.04	0.03
51	NPV of Yearly Revenue Requirements	176	153	133	116	101	88	76	66	57	50	43	37	32	28
52	NPV of 30 Years of Rev. Req. (12.07% disc't rate)														10,917
Revenue vs. CIAC Treatment															
53	Revenue vs. CIAC Treatment														Totals
54	Change in New Rev. Req. Needed	73	71	67	65	63	61	57	54	51	49	45	42	39	36
54	Cum. Change in New Rev. Req. Needed	645	716	783	848	911	972	1,029	1,083	1,134	1,183	1,228	1,270	1,309	1,345
56	Change in NPV of 30 Years of Rev. Req. (12.07% or F = D - B														
57	NPV of same stream discounted at 8%														

Schedule 3 Treatment CIAC vs. Revenue

Backup to APS 12/10/07 Letter, Exhibit C

Schedule #3 Fees Treated as CIAC														
For 1 Vintage Year Over a 30-Year Book Life														
Line	Construction Additions & New Rate Base	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12
1	Plant Additions	10,000	(1,000)											
2	Less Schedule #3 Fees Treated as CIAC	9,000												
3	Net Plant Additions After CIAC	10,000	(1,000)											
4	Cumulative Plant Additions	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0	0	0	0
5	Accumulated Book Depreciation		(300)	(600)	(900)	(1,200)	(1,500)	(1,800)	(2,100)	(2,400)	(2,700)	(3,000)	(3,300)	(3,600)
6	Original Cost Less Accum. Book Depr.	9,000	8,700	8,400	8,100	7,800	7,500	7,200	6,900	6,600	6,300	6,000	5,700	5,400
7	20 Year Macrs Tax Depr. Rate		0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
8	30 Year Book Depr. Rate		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
9	Accum. Book Depr. Rate vs. Tax Depr. Rate		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
10	Beginning Bal. of Def. Tax on CIAC	400	400	400	400	400	400	400	400	400	400	400	400	400
11	Accum. Def. Tax Reversal on CIAC		0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
12	Accum. Def. Tax on 9,000 Plant Addition		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
13	Deferred Tax Balance @ 40% Tax Rate	400	400	400	400	400	400	400	400	400	400	400	400	400
14	End of Year Rate Base	9,000	8,700	8,400	8,100	7,800	7,500	7,200	6,900	6,600	6,300	6,000	5,700	5,400
15	Revenue Requirements on New Rate Base		1,135	1,113	1,091	1,069	1,048	1,028	1,004	982	961	939	917	896
16	12.07% Return (incl. Taxes) on Beg. Rate Base		300	300	300	300	300	300	300	300	300	300	300	300
17	Annual Book Depr. (30 Year Life)		131	126	122	117	113	108	104	99	95	90	86	82
18	Property Taxes @ 1.5% on OCLD		1,566	1,539	1,513	1,486	1,461	1,434	1,408	1,381	1,356	1,329	1,303	1,277
19	New Rev. Requirements		1,135	1,113	1,091	1,069	1,048	1,028	1,004	982	961	939	917	896
20	Discount Rate		0.89	0.80	0.71	0.63	0.57	0.50	0.45	0.40	0.36	0.32	0.29	0.25
21	Years		1	2	3	4	5	6	7	8	9	10	11	12
22	NPV of 30 Years of Rev. Req. (12.07% disc't rate)		1,101	1,017	942	875	815	760	708	659	613	570	529	490
23	NPV of Yearly Revenue Requirements		1,101	1,017	942	875	815	760	708	659	613	570	529	490
24	NPV of 30 Years of Rev. Req. (12.07% disc't rate)		1,101	1,017	942	875	815	760	708	659	613	570	529	490
25	For 1 Vintage Year Over a 30-Year Book Life													
26	Construction Additions & New Rate Base	10,000	(1,000)											
27	Plant Additions	10,000	(1,000)											
28	No Adjustment for Schedule #3 Fees	10,000	(1,000)											
29	Cumulative Plant Additions	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0	0	0	0
30	Accumulated Book Depreciation		(300)	(600)	(900)	(1,200)	(1,500)	(1,800)	(2,100)	(2,400)	(2,700)	(3,000)	(3,300)	(3,600)
31	Original Cost Less Accum. Book Depr.	9,000	8,700	8,400	8,100	7,800	7,500	7,200	6,900	6,600	6,300	6,000	5,700	5,400
32	20 Year Macrs		0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
33	30 Year Book Depr. Rate		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
34	Cum. Delta		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
35	Def. Tax - Taxable Inc. Yr One		0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
36	Accum. Def. Tax on Tax Depr. Deduction		3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
37	End of Year Rate Base	9,000	8,700	8,400	8,100	7,800	7,500	7,200	6,900	6,600	6,300	6,000	5,700	5,400
38	Revenue Requirements on New Rate Base		1,135	1,113	1,091	1,069	1,048	1,028	1,004	982	961	939	917	896
39	12.07% Return (incl. Taxes) on Beg. Rate Base		300	300	300	300	300	300	300	300	300	300	300	300
40	Annual Book Depr. (30 Year Life)		131	126	122	117	113	108	104	99	95	90	86	82
41	Property Taxes @ 1.5% on OCLD		1,566	1,539	1,513	1,486	1,461	1,434	1,408	1,381	1,356	1,329	1,303	1,277
42	New Rev. Requirements Before Sch. #3		1,135	1,113	1,091	1,069	1,048	1,028	1,004	982	961	939	917	896
43	New Rev. Requirements		1,135	1,113	1,091	1,069	1,048	1,028	1,004	982	961	939	917	896
44	Discount Rate		0.89	0.80	0.71	0.63	0.57	0.50	0.45	0.40	0.36	0.32	0.29	0.25
45	Years		1	2	3	4	5	6	7	8	9	10	11	12
46	NPV of 30 Years of Rev. Req. (12.07% disc't rate)		1,101	1,017	942	875	815	760	708	659	613	570	529	490
47	NPV of Yearly Revenue Requirements		1,101	1,017	942	875	815	760	708	659	613	570	529	490
48	Revenue vs. CIAC Treatment		1,101	1,017	942	875	815	760	708	659	613	570	529	490
49	Change in New Rev. Req. Needed		1,101	1,017	942	875	815	760	708	659	613	570	529	490
50	Cum. Change in New Rev. Req. Needed		1,101	1,017	942	875	815	760	708	659	613	570	529	490
51	NPV of 30 Years of Rev. Req. (12.07% disc't rate)		1,101	1,017	942	875	815	760	708	659	613	570	529	490
52	NPV of same stream discounted at 6%		1,101	1,017	942	875	815	760	708	659	613	570	529	490
53	Revenue vs. CIAC Treatment		1,101	1,017	942	875	815	760	708	659	613	570	529	490
54	Change in New Rev. Req. Needed		1,101	1,017	942	875	815	760	708	659	613	570	529	490
55	Cum. Change in New Rev. Req. Needed		1,101	1,017	942	875	815	760	708	659	613	570	529	490
56	NPV of 30 Years of Rev. Req. (12.07% disc't rate)		1,101	1,017	942	875	815	760	708	659	613	570	529	490
57	NPV of same stream discounted at 6%		1,101	1,017	942	875	815	760	708	659	613	570	529	490

E = C - A
Sum E = D - B

[illegible]